Article excerpt

While Australia leads the United States in direct stock ownership by private individuals, Australian investors perceive foreign shares as risky and question if the benefits of international portfolio diversification can be achieved by purchasing shares in multinational corporations. Attempting to answer this question, this study compares the weekly returns, total risk and Beta of a portfolio of Australian based multinational corporations (MNC) to a portfolio of Australian domestic companies. Given that the MNC Beta exceeds the domestic Beta yet the returns are not statistically different, investment in MNC shares does not appear to provide international diversification benefits to Australian shareholders.

INTRODUCTION

A common trend across developed countries in the past decade has been the increase in ownership of company stocks by private individuals. According to the Australian Stock Exchange Share Ownership Survey 2000, Australia now ranks first among similar economies worldwide in terms of the proportion of the population who owns shares. Some 41 per cent of adults in Australia own shares directly compared to 32 per cent in the United States and 30 per cent in the United Kingdom. An additional 13 per cent of Australian adults hold shares indirectly via managed funds and personal superannuation. The increase in share ownership has occurred in tandem with the exponential growth of the multinational corporation (MNC), so much so that companies like Sony, Microsoft and Coca Cola are household names in virtually every country around the globe. Not surprisingly, investors wonder if buying stock in a MNC is a simpler means of internationally diversifying their share portfolios than purchasing foreign stock directly.

This question is particularly relevant for investors in Australia, many of whom entered the share market courtesy of floats of government authorities, such as Telecom and the Commonwealth Bank, in the early 1990s and more recent demutualisation of insurance companies. As such, many Australian investors are relatively passive in their share market involvement, with almost half of the 5.7 million Australians who owned shares directly in 1999 not actively trading. Australians hold an average of six companies in their share portfolios and, given their relative inexperience, investors prefer the convenience and familiarity of investing locally and exhibit a strong "home bias" in their share portfolios. Our study analyses the question of the international diversification benefits of investment in MNC shares by comparing the rates of return and risk realised by shareholders of Australian based MNCs to those realised by shareholders of Australian domestic firms.

THEORETICAL RATIONALE FOR INVESTING IN MNC SHARES

Modem portfolio theory argues that investors holding an internationally diversified portfolio of assets, vis-a-vis a domestically diversified portfolio, have lower risk for a given level of expected return. The gains from diversification within a single country are limited because industry sectors and hence asset returns are influenced jointly by cycles in overall economic activity. Greater gains ensue from diversification across different countries whose economic cycles are not perfectly correlated. A substantial portion of the risk that is systematic for the single country in the domestically diversified portfolio becomes unsystematic in the context of an internationally diversified portfolio. Academic researchers have long reported that international diversification produces gains for shareholders, with a recent study suggesting that an internationally diversified portfolio has one-- tenth the variability of returns of a typical domestic diversified portfolio (Solnik, 1995).

However, the ability of investors to invest in foreign shares is constrained by the extent to which national capital markets are segmented, as opposed to integrated. Market segmentation arises from imperfections in national capital markets and causes the required rates of return on comparable assets, after adjusting for foreign exchange risk and political risk, to differ between national markets. …